



# Office of the City Auditor

UTILITY BILL AND TARIFF COSTS  
SCOTTSDALE WATER SERVICE COMPANY  
CITY OF SCOTTSDALE  
OCTOBER 1991  
(Report No. 8802B)

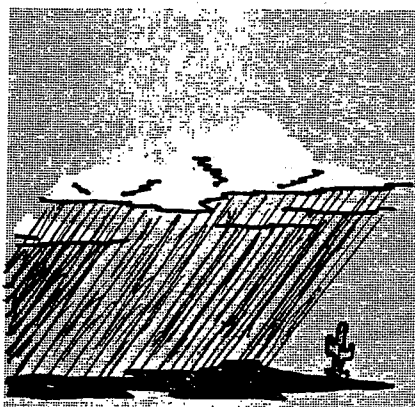
Michael L. Ashcraft  
*City Auditor*

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**SCOTTSDALE CITY COUNCIL**

Herbert Drinkwater, Mayor  
Councilman Greg Bielli  
Councilman Susan Bitter Smith  
Councilman Sam Campana  
Councilman Ross Dean  
Councilman Bill Soderquist  
Councilman Bill Walton



UTILITY BILL AND TARIFF COSTS  
SCOTTSDALE WATER SERVICE COMPANY  
CITY OF SCOTTSDALE  
OCTOBER 1991  
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**SW REFERENCE**

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October 31, 1991

Mayor Herbert R. Drinkwater, Members of the City Council and  
City Manager Dick Bowers:

This is the second of three reports which presents findings related to the City's utility account management practices. It examines the water services contract between the City and a private vendor (Scottsdale Water Service Company) and the contract between Scottsdale Water Service Company and a service provider (Envirotech Operating Services, Inc.). This project was originally approved by the Audit/Finance Committee in October 1988. In April 1989, the City Council authorized a contract with Tri Stem, Inc. to assist this Office in the completion of the review.

#### *EXECUTIVE SUMMARY*

*Between 1986 and 1990, SWSC and EOS overcharged the City \$367,236.55 including interest. When brought to the attention of management, both firms refunded amounts questioned.*

*By contract, SWSC is required to exercise diligence in the management of EOS operations at a water treatment plant in north central Scottsdale. The agreement is designed to promote operational efficiency for the City.*

*Because SWSC contract administration efforts were inadequate, substantial City audit costs were incurred. Recommendations are made to City management to seek reimbursement for these costs from SWSC and to assume a more active posture in the oversight and auditing of billings.*

As of July 1991, the City received \$367,236.55 from SWSC and EOS. Savings related to reducing or avoiding recurring costs are estimated to exceed \$42,000 per year and will be realized by the City exclusively.

As required by contract, Tri Stem receives \$179,945.91 as compensation for its efforts. The remainder would be available to support general operational efforts in the City; however, since these refunds were derived from specific user rate based systems, crediting the Water and/or Sewer Enterprise Funds would be appropriate.

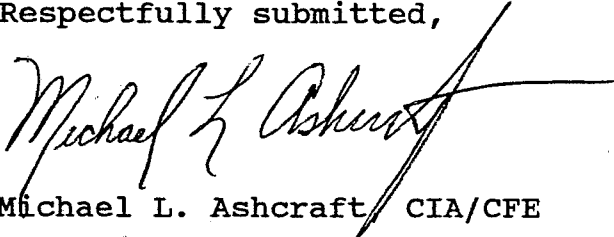
Billings submitted by SWSC for EOS and other service providers were reviewed for accuracy. Refunds were pursued where discrepancies were suspected. Contract calculations and interpretations were investigated to verify legitimacy. After some initial questions, management personnel from both EOS and SWSC worked to address issues related to suspected errors. City staff from the Water Resources and Financial Services departments, the City Attorney's and the City Manager's offices participated in this review. Responses to the audit are presented in Appendix D.

This audit was conducted in accordance with Generally Accepted Governmental Auditing Standards as they relate to contract audit services and the germane requirements specified in Article III Scottsdale Revised Code Section 2-117 et seq. and with standards applicable to utility auditing and refund collection efforts. All settlements were approved by the City Auditor under authority of the City Council.

The body of this report is divided into two sections. The first deals with findings and observations associated with the City's contractual relationship with SWSC and EOS. The second presents a summary report and the findings developed by Tri Stem. Existing contract management practices were found to be inadequate. Substantive billing adjustments were needed and verified. Copies of Tri Stems detailed analysis are on file in both this Office and with the City Clerk for public inspection.

This report examines the billing procedures and practices employed by SWSC, EOS and the City between December 1986 and June 1991. It did not include an analysis of any other contract provisions which are under review and will be released as a separate report once fieldwork and associated discussions are completed.

Respectfully submitted,



Michael L. Ashcraft, CIA/CFE

MLA:Gail Crawford, CPS

**UTILITY BILL AND TARIFF COSTS  
SCOTTSDALE WATER SERVICE COMPANY  
CITY OF SCOTTSDALE  
ACTION PLAN**

F I N D I N G	RELATED DISCUSSION (Page No.)	MANAGEMENT RESPONSE		IMPLEMENTATION STATUS		RECOMMENDATION (POTENTIAL FINANCIAL IMPACT SUMMARY) [PRIORITY: SEE APPENDIX A]
		AGREE	DISAGREE	UNDERWAY	PLANNED	
1	1, 2	X		X		<p>The City Manager in consultation with the City Attorney should seek reimbursement for costs realized by the City caused by SWSC's lack of diligence. (Cost: unknown but potentially substantial. Benefit: recoupment of audit fees of over \$180,000 not including City Auditor staff expenses.) [1]</p> <p>The Water Resources General Manager should take steps to improve the City's scrutiny of SWSC billings by:</p> <ul style="list-style-type: none"> <li>a. expanding his staff's ability to rigorously review all Contract related charges and/or</li> <li>b. assuming all audit duties directly which are currently being performed by SWSC.</li> </ul> <p>(Cost: transferred from SWSC billings to City to direct City billings. Benefit: improves City oversight capacity and eliminates SWSC's 7.5 percent audit related management fee.) [1]</p>
2	1, 2	X	X		X	



## SUMMARY OF FINDINGS AND OBSERVATIONS

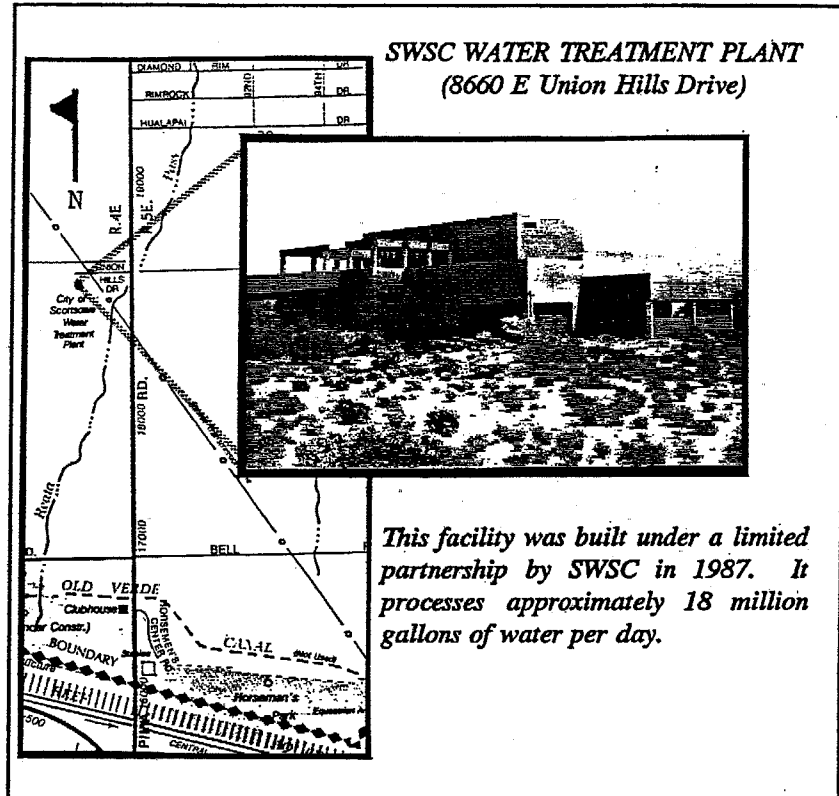
In 1984, the City contracted with SWSC to construct, operate and eventually own a water treatment plant in north central Scottsdale. (See Insert.) Financing for the project was provided by bonds through the Industrial Development Authority of the City of Scottsdale, Inc. The City's obligation to the pay debt service and these bonds is part of the contract privatization agreement.

This privatization effort was designed to allow the City to provide for a needed water treatment facility quickly and with reduced up-front costs. The contract specifies the duties and responsibilities of each party. SWSC operates the facility through EOS as the "Contract Operator." The contract assigns plant management responsibility to SWSC as part of the

7.5 percent fee paid by the City. This recompense was recognized as payment for economical and effective service:

- The Operations and Maintenance Contract (with EOS) ...shall contain such provisions as in the judgment of the City and SWSC will assure that SWSC and the City will obtain careful and competent operation and maintenance of the Facility...
- SWSC shall diligently supervise the Contract Operator [EOS] to assure that the Operations and Maintenance Contract is performed efficiently....
- SWSC hereby agrees diligently to perform all such services in accordance with terms of this Service Agreement....

(emphasis added - See Appendix B)



Recognizing this responsibility, SWSC employed the services of a local CPA firm to monitor contract billings to the City. These reviews were represented as attestations designed to ensure accuracy and were charged to the City along with SWSCs other fees.

Based on independent City audit research, SWSCs billings were found to be in error. Between December 1986 and March 1990, EOS overcharged the City \$340,780 (including interest) to which SWSC added its 7.5 percent management fee bringing the City's costs to \$367,236.55. (See Appendix C for copies of associated checks.) Once this overcharge was brought to the attention of SWSC and EOS, both firms acted aggressively to reimburse the City with interest. However, the cost of determining this error fell on the City because of SWSCs lack of diligence.

#### **RECOMMENDATION(S)**

1. The City Manager in consultation with the City Attorney should seek reimbursement for costs realized by the City caused by SWSCs lack of diligence.
2. The Water Resources General Manager should take steps to improve the City's scrutiny of SWSC billings by:
  - a. expanding his staff's ability to rigorously review all Contract related charges and/or
  - b. assuming all audit duties directly which are currently being performed by SWSC.

#### **ABBREVIATED RESPONSE(S)**

1. Agree. City Manager's office will pursue immediately.
2. Partially agree. The Water Resources Department must be cautious not to assume SWSC responsibilities as provided in the current contract. Therefore, Water Resources will retain an independent outside auditor to review SWSC records annually, beginning this fiscal year.



June 6, 1991



Mr. Michael Ashcraft, City Auditor  
City of Scottsdale  
3939 Civic Center Boulevard  
Scottsdale, AZ 85251

Dear Mr. Ashcraft:

This letter and the attached comments are submitted as final report on Tri Stem's review and analysis of billings from the CAP Water Treatment Plant Project as performed during the period June 21, 1989 through May 7, 1991. Our discussion report dated (January 21, 1991) reviewed contract compliance and contained specific data and details which we will not reiterate now. Instead, we will attempt to summarize the most significant points.

### ***SCOPE OF THE WORK PERFORMED***

The City of Scottsdale contracted with Scottsdale Water Service Company (a limited partnership) to construct, own and operate a water treatment plant funded as an Industrial Development Authority water treatment plant privatization project. Scottsdale Water Supply Company, in turn, contracted with Envirotech Operating Services, Inc. to operate the facility. The contract between Scottsdale Water Service Company (SWSC) and Envirotech Operating Services, Inc. (EOS) is dated December 23, 1986 and water production began during the latter part of April, 1987.

Billings for services are prepared by EOS and routed through SWSC where a consolidated service fee invoice is prepared. This invoice includes debt service charges, management fees, and various office and administration expenses.

Tri Stem was directed by the City Auditor to review these contractual relationships, to determine accuracy of reporting and to reconstruct and compare costs as billed (during the period December 23, 1986 through March, 1991) with costs computed by EOS and approved by SWSC. Any and all discrepancies which could be referenced to the contract were to be pursued and any refunds due the City were to be collected.

### ***BASIC CONTRACTUAL REQUIREMENTS***

The agreement and formula for computing monthly service payments are found in Exhibit B of the contract between SWSC and EOS. As described in the contract, there is first a base payment comprised of fixed and variable costs adjusted for volume fluctuations and adjusted for inflation based on the consumer price index (CPI) in the Phoenix area.

Secondly, there is a variable price payment for chemicals and electricity, also adjusted for inflation and price changes via index computations. The entire variable pricing function is wrapped in a prescribed incentive cost savings computation that was to be divided 50/50 between EOS and the City. It is based on any savings realized on chemicals and electricity when compared to a computed baseline budget amount.

### **ACCOUNTS PAYABLE ANALYSIS**

The contract also calls for a test period in which the City would be charged for the initial estimated chemicals and electrical costs as prepared by EOS and reviewed and approved by SWSC and the City. Any amounts in excess of the actual costs were to be refunded to the City each calendar quarter. The test period was apparently agreed to as fifteen months beginning April, 1987. No written documentation could be provided that stipulated this test period.

### ***SPECIFIC FINDINGS OF THE REVIEW***

Envirotech Operating Services, Inc. has offered and we have advised that the City accept a refund of \$340,780 which is comprised of \$268,519 in overcharges and \$44,528 in interest at 8 % from point of error, and \$27,733 to repurchase the initial inventory charged to the City. SWSC has agreed to refund management fees of \$25,647 and other miscellaneous refunds of \$810 for a grand total of \$367,237. Revised computations and formula relating to future billings should save the City an estimated \$38,000 per year based on the production of 4,300 mg and savings of \$8.09 per mg coupled with reduction in fixed base price of \$4,200 per year.

#### ***The Vendor's Billing Process***

The most significant finding of the review involved a failure on the part of EOS to correctly compute and apply fixed and variable electrical elements. Per contract, the fixed element is described as 575 KW, and 91,250 Kwh/month for demand and fixed energy. When these amounts are computed using Arizona Public Service Company rate schedule E-32, the initial fixed costs should have been \$112,837 per year (not \$45,343 as computed by EOS) as indicated on page B-8 of the contract. This substantial understatement of the fixed electrical costs caused an overcharge in the variable element of the bill.

The next most significant finding relates to the markup of chemicals and electrical costs by 28.2%. We are unable to find any clear reference to an allowed markup percentage except for an example on the last page of the contract which partially supports a claim for an approximate 17 % markup. EOS agreed to reduce markup on chemicals and electricity to that level and refund the difference.

We also noted that EOS had charged the City for an initial inventory of chemicals in the amount of \$27,733. Although there are no provisions in the contract for the City to assume the cost of a chemicals inventory, EOS believes transfer of such cost to the City is an "industry practice." In order to substantiate the approximate value of such inventory, Tri Stem and City employees made an unannounced visit to the facility and observed a physical inventory count which left little or no doubt that inventory amounts were reasonable and were approximately correct as to dollar value. EOS has agreed to pay the City \$27,733 for the initial inventory with the understanding that EOS will own the inventory of chemicals.

Finally, the contract provides that the Consumer Price Index for Urban Wage Earners in Phoenix should be used to adjust for inflation. However, this CPI-U for Phoenix is not prepared by the Bureau of Labor Statistics. EOS assumed that since a Phoenix CPI-U did not exist, Los Angeles' should be used by default. We argued that the CPI-W prepared by Arizona State University would bear more relevance to actual inflation costs in the Scottsdale area. By using this local index, the City would have saved \$7,000 - \$8,000 over the time period in question. EOS agreed to use the local index beginning July 1, 1990.

## ***Program Management (SWSC)***

Scottsdale Water Service Company's apparent principal function is to administer the contract for operation of the water treatment plant. In accordance with the contract, the City pays a management fee of 7.5% plus various administrative costs and expenses. During the period of time under examination, the total management fees paid were approximately \$276,172 plus \$55,528 (without the 1990 audit fee) for accounting and auditing services from local and national Certified Public Accountants. Neither management nor the accountants uncovered the billing errors noted above.

## ***City Staff***

Billings, as passed through from SWSC, were paid by City staff members as required by contract. Questions were raised, on occasion, regarding clerical accuracy and various elements of the bills (such as audit fees). However, staff did not attempt to reconstruct basic costs or to compare any reconstructed costs with billings as received and paid, or with the contract. Staff apparently assumed that SWSC billings were correct.

To some extent, the inability to reconstruct costs and/or to adequately review billings is attributed to a lack of documentation offered by EOS (as routed through SWSC to the City). Lack of documentation was a serious impediment to completion of our review.

The City could begin by insisting on complete documentation, and, if necessary, it could refuse to approve bill payments until needed documents were secured.

## ***RECOMMENDATIONS FOR THE FUTURE***

1. Exhibit B of the contract between SWSC and EOS for operation of the water treatment plant is in serious need of complete overhaul and the City must take an active part in that process.

Although an incentive billing program may be admirable in theory, such programs have absolutely no chance of success unless they are simplified to the point that all parties completely understand them and particularly understand the computational elements. As presently outlined in Exhibit B of the contract, it is highly unlikely that any of the parties fully comprehend (and certainly they don't agree) what the contract calls for in the way of billings.

In view of this status, we seriously recommend the formulas and incentive program be junked and that new and fresh approaches, that are easily understood and computed, be applied. A revised agreement should be very specific in regard to what the City is to pay.

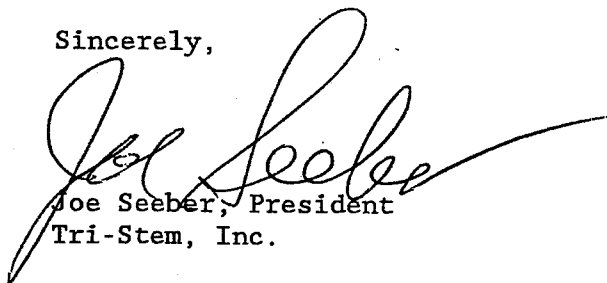
In this regard, we recommend the City take over payment of the electrical portion of the facility costs. The City qualifies for a municipal water pumping rate from Arizona Public Service Company which is not available to SWSC or EOS. The approximate cost for water plant electricity as computed using rate E-32 (Standard General Service Rate) is \$51,100 per year whereas rate E-221 (Municipal Water Pumping Rate) would cost approximately \$42,800 with a net annual savings of \$8,300.

2. Communications between the City and EOS are hampered, to some extent, by the requirement that all communications be channeled through SWSC. We recommend a more direct communication between EOS and the City and such communication should perhaps take the form of routine and recurring conferences.
3. At the least, the City should hire and direct the performance of accountants and auditors who audit SWSC and who provide services related to the review of billings of the water treatment plant operator (EOS). Direction, in the form of specific objectives to analyze compliance with contractual requirements, should be provided by the City.

We have reviewed billings as currently being presented and have noted that EOS has adjusted the variable billing rate to \$63.19 per mg and has made the agreed adjustments to fixed base price.

We thank you for the opportunity to serve the City of Scottsdale and if we can provide further information regarding this matter, please be sure to contact us.

Sincerely,



Joe Seeber, President  
Tri-Stem, Inc.

## ***APPENDICES***

**APPENDIX A  
DEFINITIONS OF PRIORITY  
CLASSIFICATIONS FOR AUDIT  
RECOMMENDATIONS**

**PRIORITY  
CLASSIFICATION**

**DESCRIPTION**

- |   |   |
|---|---|
| 1 | <i>Fraudulent practices or other serious violations are being or have been committed resulting in significant financial or equivalent non-financial losses to the City.</i> |
| 2 | <i>The potential for incurring significant financial or equivalent non-financial losses exists.</i>   |
| 3 | <i>Administrative, operational, or programmatic process can be improved.</i>  |

**APPENDIX B**  
**Excerpt From:**  
**CITY OF SCOTTSDALE CENTRAL ARIZONA PROJECT**  
**WATER TREATMENT FACILITY SERVICE AGREEMENT**  
**By and Between**  
**CITY OF SCOTTSDALE, ARIZONA**  
**and**  
**SCOTTSDALE WATER SERVICE COMPANY LIMITED PARTNERSHIP**

1. **ARTICLE IV - OPERATION AND MAINTENANCE OF THE FACILITY**  
**(4.1. The Operations and Maintenance Contract) page 25**
2. **ARTICLE II - ENGAGEMENT OF SWSC**  
**(2.1 Engagement for Services) page 14**



~~Contracts shall be in full force and effect and the Construction Manager and other contractors and subcontractors shall not be in default under the Construction Contracts; and (v) the Bond proceeds shall be available for application under the Loan Agreement to payment of Facility Costs.~~

#### ARTICLE IV

##### OPERATION AND MAINTENANCE OF THE FACILITY

###### 4.1. The Operations and Maintenance Contract —

(a) SWSC shall operate the Facility through the Contract Operator under the terms of the Operations and Maintenance Contract. The Operations and Maintenance Contract shall be approved by the City prior to its execution by SWSC and shall contain such provisions as in the judgment of the City and SWSC will assure that SWSC and the City will obtain careful and competent operation and maintenance of the Facility, including a provision allowing the City to periodically inspect and copy the accounting and other books and records of the Contract Operator in a reasonable manner. Performance of its obligations under the Operations and Maintenance Contract by the Contract Operator shall, to the extent relevant, constitute performance by SWSC of its obligations hereunder.

(b) SWSC shall diligently supervise the Contract Operator to assure that the Operations and Maintenance Contract is performed efficiently and that repairs and maintenance are promptly and correctly carried on in a manner consistent with the long-term maintenance of the Facility and directions provided by the City. In the event that the Contractor Operator institutes or has instituted against it a proceeding in bankruptcy or for insolvency or for any reorganization, arrangement, debt adjustment, liquidation or receivership, in which it is alleged that the Contractor Operator is unable to meet its debts as they mature, SWSC shall ensure that such proceedings do not cause a stoppage of the Facility's operations and the Operations and Maintenance Contract shall contain provisions calculated to ensure such result to the extent possible under applicable law.

(c) The City may at any time give notice to SWSC to correct any defects in the Contract Operator's performance under the Operations and Maintenance Contract and may require SWSC, upon 90 days notice, to hire a replacement Contract Operator in the event the Operations and Maintenance Contract is not performed efficiently and that repairs and maintenance are not carried on in a manner consistent with the long-term maintenance of the Facility.

~~(c) suspension, termination, interruption or failure of renewal of any permits, license, consent, authorization, or approval essential to the construction or operation of the Facility as provided for herein or required with respect hereto, if it is not also the result of willful or negligent action or other material fault of the party relying thereon, provided that the act of contesting or not contesting any such suspension, interruption, or failure of renewal, if such contest or failure to contest is in good faith, shall not itself be construed as a willful or negligent action of such party, though such contest, if resolved against the contestant, shall ameliorate or otherwise reduce the burden of such contestant as a result of the suspension, termination, interruption, or failure contested;~~

~~(d) adoption, promulgation, modification of or change in interpretation of any federal, state, local, or foreign rule or law, regulation or ordinance after the Execution Date, to the extent that the effect of such change cannot be reasonably accommodated pursuant to Section 7.1;~~

~~(e) the failure of any contractor (other than the Construction Manager or the Contract Operator), subcontractor, or supplier to furnish labor, services, materials, or equipment on the date agreed to, provided that such failure materially adversely affects SWSC's ability to perform its obligations and further provided that SWSC is not reasonably able to obtain substitute labor, services, materials, or equipment; or~~

~~(f) the failure of the City or the appropriate federal or state agencies or public or private utilities (sic) having operational jurisdiction in the area of location of the Facility to provide and maintain all utilities, services, sewerage, and water lines to the Facility as per the Site plans provided that the utilities, services, sewerage, and water lines not so provided or maintained are essential to the normal construction or operation of the Facility.~~

~~Water Service Subcontract shall mean the Subcontract among the United States Department of Interior Bureau of Reclamation, the Central Arizona Water Conservation District, and the City of Scottsdale providing for Raw Water from the Central Arizona Project.~~

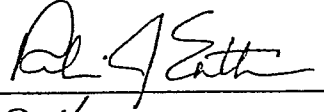

## ARTICLE II

### ENGAGEMENT OF SWSC

#### 2.1 Engagement for Services

The City hereby contracts with SWSC to purchase from it the services hereinafter described at and for the compensation herein stated, and SWSC hereby agrees diligently to perform all such services in accordance with the terms of this Service Agreement and for the City's annually renewable promise to pay such compensation.

1.

<b>EOS</b>   Envirotech Operating Services, Inc. 1165 Northchase Parkway • Suite 325 Marietta, GA 30067 404-953-6005	Mellon Bank N.A. Pittsburgh, Pennsylvania		009479
	CHECK DATE 4-23-91	CONTROL NUMBER	CHECK AMOUNT 313,047.00
PAY THREE HUNDRED THIRTEEN THOUSAND AND FORTY SEVEN DOLLARS*****			
TO THE ORDER OF THE CITY OF SCOTTSDALE AND SCOTTSDALE WATER SERVICE COMPANY	  AUTHORIZED SIGNATURE		

⑈009479⑈ ⑆043301601⑆ 176⑈2293⑈

2.

ENVIROTECH OPERATING SERVICES				14967		
OUR REF. NO.	YOUR INV. NO.	INVOICE DATE	INVOICE AMOUNT	AMOUNT PAID	DISCOUNT TAKEN	NET CHECK AMOUNT
	Final Settlement tri- Scottsdale plant		Stem audit 27,733.00	27,733.00		27,733.00

## ENVIROTECH OPERATING SERVICES

WESTERN REGION  
 400 S. EL CAMINO REAL, SUITE 595  
 SAN MATEO, CA 94402  
 PH. 415-343-5663

MELLON BANK N.A.  
 PITTSBURGH, PA 15238  
 60-160-433

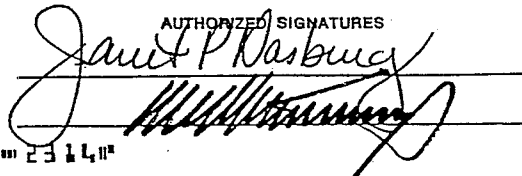
14967

CHECK DATE	CONTROL NO.	CHECK AMOUNT
6/6/91	14967	\$27,733.00****

PAY Twenty Seven Thousand, Seven Hundred Thirty three and 0/100-----


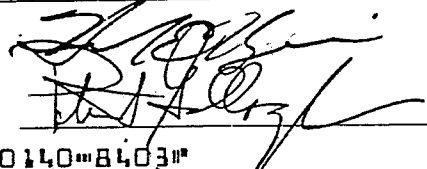
TO THE ORDER OF  
 City of Scottsdale  
 and  
 Scottsdale Water Service Company

AUTHORIZED SIGNATURES


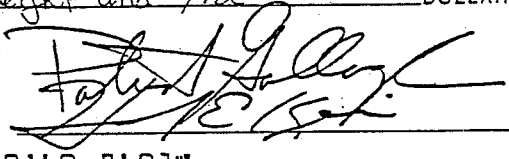


⑈014967⑈ ⑆043301601⑆ 176⑈2314⑈

3.

<b>SCOTTSDALE WATER SERVICE CO.</b> LTD. PARTNERSHIP 16601 N. PIMA RD. 602-951-0913 SCOTTSDALE, AZ 85260		1405 91-2/1221
		April 25 19 91
PAY TO THE ORDER OF	City of Scottsdale	\$ 23,478.53
Twenty-three thousand four hundred seventy-eight and 53/100----- DOLLARS		
<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;">  <b>HILTON VILLAGE OFFICE (286)</b>            P.O. Box 29549            Phoenix, Arizona 85038         </div> <div style="text-align: right;">  </div> </div>		
FOR Management Fee Refund		
@00001405 @122100024 @01408403		

4.


<b>SCOTTSDALE WATER SERVICE CO.</b> LTD. PARTNERSHIP 16601 N. PIMA RD. 602-951-0913 SCOTTSDALE, AZ 85260		1415 91-2/1221
		7/3 19 91
PAY TO THE ORDER OF	City of Scottsdale	\$ 2,978.02
Two thousand nine hundred seventy-eight and 02/100----- DOLLARS		
<div style="display: flex; justify-content: space-between; align-items: center;"> <div style="text-align: left;">  <b>HILTON VILLAGE OFFICE (286)</b>            P.O. Box 29549            Phoenix, Arizona 85038         </div> <div style="text-align: right;">  </div> </div>		
FOR Final & Complete Settlement		
@00001415 @122100024 @01408403		

**APPENDIX D**  
**UNABRIDGED MANAGEMENT RESPONSES**

1. *Water Resources Department (October 11, 1991)*
2. *Burch & Cracchiolo, P.A. for SWSC (October 11, 1991)*
3. *City Auditor comments on Burch & Cracchiolo letter*

October 11, 1991

TO: Mike Ashcraft, City Auditor

FROM:  Roger Klingler, Assistant General Manager

SUBJECT: SWSC Audit - Management Response

Attached please find the Water Resources Department Management Response to the recommendations in your Utility Bill & Tariff Costs Scottsdale Water Service Company Report.

Please let me know if you have questions regarding this response.

cc: Dick Bowers, City Manager  
Barbara Burns, Assistant City Manager  
Leonard L. Dueker, General Manager, Water Resources

SWSC Audit

Management Response

**1. Recommendation:** The City Manager in consultation with the City Attorney should seek reimbursement for costs realized by the City caused by SWSC's lack of diligence


**Response:** Agree. City Manager's office will pursue immediately

**2. Recommendation:** The Water Resources General Manager should take steps to improve the City's scrutiny of SWSC billings by:

- a. expanding his staff's ability to rigorously review all Contract related charges and/or
- b. assuming all audit duties directly which are currently being performed by SWSC.

**Response:** Partially Agree. The Water Resources Department must be cautious not to assume SWSC responsibilities as provided in the current contract. Therefore, Water Resources will retain an independent outside auditor to review SWSC records annually, beginning this fiscal year.

Submitted by:

  
Roger Klingler  
Assistant General Manager  
Water Resources Department



# BURCH & CRACCHIOLO, P.A.

ATTORNEYS AT LAW

DANIEL CRACCHIOLO  
JACK DANIEL KLAUSNER  
DARYL MANHART  
EDWIN C. BULL  
ANDREW ABRAHAM  
F. MICHAEL CARROLL  
RALPH D. HARRIS  
MARTHA C. PATRICK  
BRIAN V. PEARSON  
EVE PARKS  
KAREN C. PAUL

STEPHEN E. SILVER  
LUPE INIGUEZ-ESPINOZA  
IAN NEALE  
BRYAN F. MURPHY  
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BRAD S. OSTROFF  
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October 11, 1991

HAND DELIVERY

(602) 234-9921

Mr. Michael L. Ashcraft  
City Auditor  
CITY OF SCOTTSDALE  
7440 East First Avenue  
Scottsdale, AZ 85251

Re: Scottsdale Water Service Company - Tri Stem Audit

Dear Mr. Ashcraft:

The firm of Burch & Cracchiolo, P.A. has been retained by Scottsdale Water Service Company ( "SWSC" ) to review and to provide comments on the draft Special Report to Scottsdale City Council, entitled Utility Bill and Tariff Costs, Scottsdale Water Service Company, City of Scottsdale, September 1991 (Report No. 8802B) ("Preliminary Report") pursuant to your September 12, 1991 letter to SWSC.

SWSC certainly will support and work closely with the City of Scottsdale ("City") to implement all feasible recommendations contained in the Preliminary Report. Such recommendations include modifications to the billing methodology in Exhibit B of the December 23, 1986 Operations and Maintenance Agreement between SWSC and Envirotech Operating Services, Inc. ( "EOS" ) ( "O&M Agreement" ) and improvements to communications and auditing practices. SWSC fully intends to continue to manage the operations of the Central Arizona Project Water Treatment Facility ( "CAP Plant" ) in the best interest of the City, and welcomes the opportunity to utilize its experience with the City over the past four years to enhance operations in the future.

## I. General Matters

With regard to certain other aspects of the Preliminary Report -- each of which is detailed below -- SWSC is extremely disappointed and strongly urges their deletion or modification.

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After some general observations, comments on specific aspects of the draft June 6, 1991 letter to you from Tri Stem, Inc. ("Tri Stem") are presented below, followed by comments on the "Summary of Findings and Observations" section and your proposed transmittal letter. The page references cited below relate to the overall pagination of the Preliminary Report.

## II. General Comments

The Preliminary Report must be reviewed and analyzed in relation to the responsibilities outlined in the service agreement between the City and SWSC. That agreement requires SWSC to perform its obligations under the agreement "diligently." Nowhere within the four corners of the agreement is the term "diligent" defined. Terms that are not specifically defined under an agreement will be construed according to their usual use. Accordingly, "diligent", with respect to SWSC's obligations under the agreement, could be described by a steady, earnest effort.

[1]

It is clear from the facts and circumstances surrounding the items at issue that SWSC performed its duties "diligently" by employing services of an outside local CPA firm to monitor contract billings of the City, by reviewing the billing process itself and by turning over the billings and related documents to the City for its own review and analysis. What the Preliminary Report attempts to do is require SWSC to guaranty the accuracy of all billings. This is not called for under the agreement and is, due to the complexity of the billing arrangements and the fact that another entity (EOS) is involved, impracticable.

Moreover, as far as SWSC's responsibilities to pay any audit fees that are incurred because of the mistake in billings, it is clear that the agreement requires the city to bear such costs. (See section 5.8 of the agreement.) This is especially appropriate in this case where SWSC had absolutely no say in what auditor was hired and no say in the billing arrangement which was reached between Tri Stem and the city. As more specifically discussed below, the fees charged by Tri Stem do not correlate to usual audit practices and, since they are contingent in nature and based on a percentage of recovered amounts, bear no relation to reasonable and customary fees. Even if the Tri Stem fee arrangement was a customary one, the magnitude of the actual fee paid by the City could have been greatly reduced if the City had instituted such audit in a more timely fashion, i.e., in the first year rather than the fourth year of EOS billings.

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Given the above legal and factual framework, SWSC intends to vigorously defend against any attempt on the part of the City to press a claim against SWSC for reimbursement of the Tri Stem audit fee. We, frankly, do not understand how the City could justify the expenditures it would incur in pursuing a claim of such questionable merit.

In concluding the general observations, SWSC would like to put the City on notice that the City and Tri Stem will be held responsible for any damage caused to the reputation of the business entities or individuals associated with SWSC as a result of distribution or publication of the Preliminary Report, either in its current form or as modified. We are of the belief that several statements contained in the Preliminary Report are potentially libelous in nature. It would be advisable for the City to conduct all discussions relative to these matters in closed Executive Session, given the likelihood of litigation resulting from any public distribution or disclosure of the Preliminary Report.

### III. Draft June 6, 1991 Letter From Tri Stem

The Scottsdale Water Service Company is erroneously referred to as the Scottsdale Water "Supply" Company on two occasions (pages 3 and 5.) This error should be corrected. [2]

Also on page 3, it would be appropriate in the second paragraph to note that the terms of the O&M Agreement were subject to detailed review and comment by the City (including legal counsel) prior to signing by SWSC and EOS. In fact, the extensive degree of City input resulted in several significant changes to the O&M Agreement, including modifications to the billing methodology set forth in Exhibit B, and insertion of the following clause granting specific audit rights directly to the City: "The City, at its expense, may periodically inspect and copy the accounting and other books and records of EOS related to the variable costs, including the computation of chemical and power cost savings and baseline budgets, for the services provided under this Agreement." As it turns out, the full amount of reimbursements recovered by Tri Stem relate exclusively to EOS billings for such variable costs of power and chemicals. [3]

Moreover, in order to provide an accurate description of the consolidated service fee invoice prepared monthly by SWSC, the description in paragraph three, page 3, should be restated as follows: "This invoice included a Base Fee comprising bond interest, bond principal, liquidity fees, and miscellaneous financial fees, and an Operating Fee comprising EOS contract billings, management fee, [4]

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ground lease, insurance, and administrative expenses." Also on page 3, the description in paragraphs five and six of the payment formula in Exhibit B of the O&M Agreement fails to mention security, which is a third element in the payment formula. [5]

On page 4, the reference in the initial paragraph to Camp Dresser & McKee Inc. should be deleted since Camp Dresser & McKee Inc. did not, in fact, prepare estimates of chemical or electrical costs for the test period and, even if it did, such estimates are not at issue in the subject report or audit. For the record, Camp Dresser & McKee Inc. was the design engineer for the water treatment plant, and in that capacity indicated the kinds and quantities of chemicals that could be expected to be utilized for plant operations under certain design conditions. These facts are not relevant to the subject matter of the Preliminary Report. Moreover, the initial estimates of chemical and electrical costs included in the Variable Pricing on Table A of Exhibit B of the O&M Agreement were prepared by EOS and reviewed and approved by SWSC and the City. [6]

Also on page 4, the sentence at the end of paragraph three does not make sense and should be deleted. An error, by definition, is an unintentional or accidental deviation. Such unintentional or accidental acts are not usually explainable in terms or reasons for their occurrence. To state that "the reason for the error was not determined" is to imply that something other than an error caused the overcharge on the electrical portion of the variable element of the bill. The third paragraph on page 4 provides a clear summary of the problem found. The last sentence is a gratuitous addition that does nothing but provide confusion. [7]

Also on page 4, the statement in paragraph four that Tri Stem was unable (except for the example cited) to find any reference to an allowed markup ignores the fact that Table A of Exhibit B to the O&M Agreement clearly states that both the Fixed and Variable Prices include overhead and profit (i.e., markup). Since there does not appear to be any question that such Variable Prices are for chemicals and electricity, the Table A reference to inclusion of overhead and profit is an obvious reference to an allowed markup of chemicals and electricity. This holds true when the methodology of Exhibit B is applied to adjust the Variable Pricing for future billing periods. Such methodology utilizes actual costs to compute ratios or indexes that adjust the original Variable Pricing, inclusive of overhead and profit, for future billings. [8]

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An allowed markup is clearly part of the original Variable Pricing of chemicals and electricity and this allowed markup is carried forward into subsequent billing periods by following the contractual billing procedure. The fourth paragraph on page 4 should be modified to indicate that the contract supports a markup of chemical and electrical costs. The second sentence of such paragraph should be rewritten as follows: "Although the allowed rate of markup by EOS for variable chemical and electrical costs is not specifically identified in the contract, the billing adjustment methodology set forth in Exhibit B supports an approximate 17% markup."

On page 5, the initial paragraph does not correctly portray the function of SWSC nor does it accurately describe the disposition of the 7.5% management fee paid by the City. There is no question that a key function of SWSC, now that the CAP Plant has been constructed, is administration of the O&M Agreement. Contrary to what is stated and implied elsewhere in the Preliminary Report, however, SWSC administration of the O&M Agreement is not merely a matter of receiving EOS billings and passing them on to the City. SWSC spends a great deal of effort overseeing the day-to-day operations and maintenance by EOS of the CAP Plant. Such oversight activities include regular meetings with the CAP Plant Manager to discuss specific plant operations and maintenance issues (such as performance and adequacy of plant personnel, performance of plant equipment and maintenance needs, review of preventative maintenance program activities, modification to plant operating procedures aimed at improving efficient, capital improvement needs, etc.), frequent inspections of the physical plant, periodic meetings with EOS management to evaluate performance by EOS under the O&M Agreement and the like. [9]

Actual performance of the CAP Plant in meeting the City's needs for treated CAP water has been outstanding and the physical plant is being maintained in excellent condition, both of which speak highly about the administrative efforts of SWSC. As a particular case in point, during a two month period early in 1991, when the water delivered by the CAP canal was of extremely poor quality, every CAP water treatment plant in the Valley (including those operated by the cities of Phoenix, Mesa and Glendale) was shut down. The efforts of SWSC and EOS were such that the CAP Plant serving the City was able to continue operations without interruption.

Moreover, additional functions carried out by SWSC in its management of the CAP Plant include preparing monthly service fee invoices (the elements of which were outlined earlier), bookkeeping for some \$3.0 million in annual revenues and expenses, tracking and [10]

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arranging for the payment of various invoices apart from EOS invoices under the O&M Agreement, working with the Trustee (Valley National Bank) to carry out the terms of the Trust Indenture, coordinating the activities of SWSC's outside accountant regarding the preparation and filing of annual financial statements and federal and state tax returns, and maintaining communications with the City and Ford Motor Credit Company.

With regard to the 7.5% management fee paid by the City, it should be noted that during the period in question, approximately \$200,000 in fixed management fees were retained by SWSC (an average of some \$50,000 per year) for its management services with the balance going to Ford Motor Credit Company as annual cash distributions. So, contrary to what is stated in the initial paragraph on page 5, SWSC actually was paid management fees of approximately \$200,000 not the \$267,172 amount indicated, and those fees were paid for management activities exceeding the scope that is described by Tri Stem. In summary, the initial paragraph on page 5 overstates the amount of management fees actually retained by SWSC and understates the scope of management functions actually carried out by SWSC.

Also on page 5, it is unclear what is meant by the last sentence in the second paragraph, which reads as follows: "Staff apparently relied on SWSC's indications that billings were correct." Although SWSC performed a careful review of all invoices before forwarding such invoices to the City, SWSC did not represent to City staff that all billings were "correct". On the basis of its review, SWSC believed the invoices to be correct. However, to assure City staff that such billings were correct would invite City staff to ignore its responsibility in reviewing invoices for accuracy prior to authorizing payment. SWSC did not "indicate" anything that would invite City staff to reduce the level of scrutiny normally applied by the City to vendor invoices. Considering the fact that management fees retained by SWSC during the period in question were fixed amounts (as indicated above), SWSC would not and, in fact, did not benefit from any overcharges by EOS. It is suggested that the last sentence in paragraph two on page 5 be deleted or be restated as follow: "Staff apparently assumed that SWSC billings were correct." [11]

Paragraph three on page 5 should be deleted in its entirety. This paragraph is a combination of speculation and misstatement. With regard to the assertion that a lack of documentation was offered by SWSC, all billings by SWSC to the City were accompanied by detailed backup invoices and related materials and any requests made by City staff for additional documentation were satisfied. To state



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that City staff was unable to adequately review billings or to reconstruct costs due to lack of documentation supplied by SWSC is simply untrue. Also, to speculate on a "perception" by EOS in relation to its billing documentation does nothing more than to urge the reader to draw random and baseless conclusions.

Paragraph four on page 5 effectively equates the City's insistence on complete documentation with taking over the management role of SWSC. As indicated earlier, SWSC's management role is by no means limited to administration of the O&M Agreement. Furthermore, insisting that adequate documentation be supplied by EOS does not begin to adequately describe SWSC's actual administrative activities associated with the O&M Agreement. The last sentence in the paragraph should, accordingly, be deleted. [12]

With reference to the Recommendations For The Future appearing on pages 5 and 6, the following comments are offered. Recommendation No. 1 calls for a "complete overhaul" of the O&M Agreement. While SWSC stands ready to consider any changes in the O&M Agreement that would be in the City's best interest, the problems encountered to date have been limited to the overly complex billing methodology set forth in Exhibit B. Unless there are many provisions in addition to Exhibit B where Tri Stem is recommending modifications, it is suggested that the "complete overhaul" language be limited to Exhibit B. With regard to Recommendation No. 3, any changes to the hiring of accountants for SWSC must be consistent with SWSC's obligations under its limited partnership agreement with Ford Motor Credit Company. [13]

As indicated earlier, SWSC is eager to implement constructive and feasible recommendations that are in the best interests of the City of Scottsdale and that would enhance the level of services provided by the CAP Plant.

#### IV. Summary of Findings and Observations

Since this section of the Preliminary Report appears to be based largely upon the contents of the draft June 6, 1991 letter to you from Tri Stem, it is assumed that this section will be modified to reflect any modifications to the Tri Stem letter. In any event, some additional comments are offered as follows.

On page 1, the opening sentence incorrectly refers to 1986 as the date that the City contracted with SWSC. The correct date is 1984, or more specifically December 18, 1984. Also on page 1, the statement that "this recompense was recognized as payment for economical and effective services...", followed by three phrases



Mr. Michael L. Ashcraft  
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quoted from the Service Agreement, presents a conclusion that is not supported by the quoted phrases nor by anything else in the Service Agreement. The 7.5% management fee paid by the City is for two separate purposes: (a) a portion of it compensated SWSC for a broad range of management services related to the CAP Plant, and (b) a portion of it was paid to Ford Motor Credit Company to provide an annual cash return for its equity investment which has the effect of saving the City more than \$100,000 per year in avoided bond interest costs. Incidentally, during the period covered by the Tri Stem audit, approximately \$350,000 in interest costs were avoided by the City in this regard. This compares to total management fees of approximately \$276,172 paid by the City during the same period according to Tri Stem.

On page 2, the conclusion in the first paragraph that "these reviews were represented as attestations. ..." is presented without support and is simply incorrect. SWSC's employment of a local CPA firm to review contract billings to the City was not represented as an "attestation". Such professional services were obtained by SWSC not to attest to or guarantee any particular result but as a prudent step to carry out its obligations under the O&M Agreement and as part of SWSC's overall process in meeting its obligations under the agreement. [14]

On page 2 at the end of the second paragraph, it reads: "However, the cost of determining this error fell on the city because of SWSC's lack of diligence." Also on page 2 and presented as part of recommendation one, the following phrase is included: "... costs realized by the City caused by SWSC's lack of diligence." Both statements reflect two faulty findings: (1) they include erroneous allegations that SWSC did not act diligently in accordance with the Service Agreement, and (2) they draw the incorrect conclusion that there is a causal connection between SWSC's actions and the City's independent dealings with Tri Stem. Any such conclusion is without merit and is in direct conflict with the legal provisions and factual circumstances governing this issue.

The fact that SWSC's and the City's normal invoice review procedure did not uncover the overcharges by EOS under the O&M Agreement is regrettable. However, given the nature of the overcharges and the extremely complex contractual provisions governing computation of such billings and adjustments, no amount of diligence reasonably exercised by SWSC or City staff would necessarily have identified the problem. What was needed in this instance was a detailed audit specifically directed at the computations and billings

Mr. Michael L. Ashcraft  
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under the O&M Agreement. Such an audit is not required as a matter of diligence in SWSC's administration of the O&M Agreement.

As indicated earlier, Section 3.11 of the O&M Agreement provides that the City "at its expense" may audit variable costs incurred under the O&M Agreement. Section 6.13 of the O&M Agreement expressly designates the City as a third party beneficiary. In addition, Section 5.8 of the Service Agreement provides that the City shall pay the cost of audits of adjustments to the Operating Fee which, as defined in Article I, includes variable costs incurred by SWSC under the O&M Agreement. Given this contractual framework, it is difficult to see how SWSC "caused" the City to incur the audit costs in question.

With respect to the magnitude of the City's audit costs, which appears to be some 49% of the overcharges identified, it is also difficult to see how SWSC has "caused" such costs to fall on the City. The City, unilaterally, decided to enter into the unusual fee arrangement with Tri Stem rather than a normal auditing fee arrangement based on reasonable compensation for actual efforts. In any event, SWSC had no part in making this arrangement and did not otherwise cause the City to incur such unusual audit costs. [15]

#### V. Proposed Transmittal Letter

It is assumed that changes made to the June 6, 1991 letter from Tri Stem and to the Summary of Findings and Observations section will also result in appropriate modifications to your proposed transmittal letter included as (i) through (iii) in the Preliminary Report. In addition, it is requested that the initial sentence in the Executive Summary be modified to separately indicate the overcharges by SWSC and by EOS rather than showing a combined total. Such amounts would be \$26,456.55 (including interest) in the case of SWSC and \$340,780 (including interest) in the case of EOS. This would make this sentence both consistent with the copies of checks presented in Appendix C and with the sentence that follows it.

The first sentence in the third paragraph of the Executive Summary should be deleted as per earlier comments relating to the lack of any connection between SWSC's diligence and the City's audit costs. To the extent that the Executive Summary introduces a new concept based on "inadequate" administration efforts, such characterization is not correct. The failure of SWSC to identify overcharges by EOS resulting from an admittedly complex and difficult to comprehend billing methodology hardly amounts to inadequate administration.

Mr. Michael L. Ashcraft  
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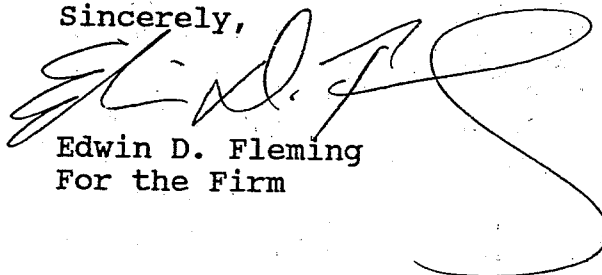
In fact, as indicated on page 4 of the Preliminary Report, apart from the EOS billing problems, a grand total of \$810 in SWSC billing errors was identified by Tri Stem. Such billing errors are the only ones relating directly to SWSC's administrative responsibility to compile monthly service fee invoices for payment by the City. Taken in the context of more than \$8.0 million of SWSC billings compiled directly by SWSC during the subject time frame, such \$810 would appear trivial and reflective of excellent work on the part of SWSC.

With regard to the Priority Classifications of the Recommendations indicated on page (iii) of the transmittal letter, it is strongly urged that a classification of "3" or "2" is more appropriate than "1". The key finding of the Tri Stem audit relates to an honest mistake made by EOS in the application of a very complex billing methodology. To suggest that this rises to the level of "fraudulent practices or other serious violations" is not justified by the circumstances. Likewise, to suggest that SWSC's behavior in the billing process be characterized this way is clearly not justified and runs contrary to the fact that SWSC met its responsibilities with regard to EOS billings under the agreement.

Concerning the recommendation on page (iii) that "all" audit duties of SWSC be directly assumed by the City, the obligations of SWSC under its limited partnership agreement with Ford Motor Credit Company must be taken into account in any such change. Also, it is not feasible under the current agreement to transfer to direct City billings, as indicated on page (iii), and we do not understand the note on page (iii) that concludes that such a transfer "... eliminates SWSC's 7.5% related management fee." As indicated earlier, the 7.5% management fee paid by the City goes towards two items: (a) SWSC management fees, and (b) annual cash distributions to Ford Motor Credit Company. Also as indicated earlier, the management activities of SWSC address many areas in addition to the review and compilation of EOS billings. The 7.5% management fee cannot be eliminated by any unilateral action by the City.

Representatives of SWSC are available to meet with you and with representatives of Tri Stem to further discuss the contents of the Preliminary Report and the comments provided above.

Sincerely,



Edwin D. Fleming  
For the Firm

EDF:dls

City Auditor Comments on Burch & Cracchiolo Letter

- [1] diligence -  
1. Persistent application to one's work: assiduous effort.  
2. Careful attention.

diligent - Marked by persevering, painstaking effort: ASSIDUOUS.

- Webster's II New Riverside University Dictionary 1984

Diligence - Vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety. Attentive and persistent in doing a thing; steadily applied; active; sedulous; laborious; unremitting; untiring.

There may be a high degree of diligence, a common degree of diligence, and a slight degree of diligence, with their corresponding degrees of negligence. Common or ordinary diligence is that degree of diligence which men in general exercise in respect to their own concerns; high or great diligence is of course extraordinary diligence, or that which very prudent persons take of their own concerns; and low or slight diligence is that which persons of less than common prudence, or indeed of any prudence at all, take of their own concerns.

*Due diligence.* Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.

*Extraordinary diligence.* That extreme measure of care and caution which persons of unusual prudence and circumspection use for securing and preserving their own property or rights.

*Great diligence.* Such a measure of care, prudence, and assiduity as persons of unusual prudence and discretion exercise in regard to any and all of their own affairs, or such as persons of ordinary prudence exercise in regard to very important affairs of their own.

*High diligence.* The same as great diligence.

*Low diligence.* The same as slight diligence.

*Necessary diligence.* That degree of diligence which a person placed in a particular situation must exercise in order to entitle him to the protection of the law in respect to rights or claims growing out of that situation, or to avoid being left without redress on account of his own culpable carelessness or negligence.

*Ordinary diligence* is that degree of care which men of common prudence generally exercise in their affairs, in the country and the age in which they live.

*Reasonable diligence.* A fair, proper and due degree of care and activity, measured with reference to the particular circumstances; such diligence, care, or attention as might be expected from a man of ordinary prudence and activity.

*Special diligence.* The measure of diligence and skill exercised by a good business man in his particular specialty, which must be commensurate with the duty to be performed and the individual circumstances of the case; not merely the diligence of an ordinary person or non-specialist.

*Diligent.* Attentive and persistent in doing a thing; steadily applied; active; sedulous; laborious; unremitting; untiring.

*Diligent inquiry.* Such inquiry as a diligent man, intent upon ascertaining a fact, would ordinarily make, and it is inquiry made with diligence and good faith to ascertain the truth, and must be an inquiry as full as the circumstances of the situation will permit.

- *Black's Law Dictionary with Pronunciations (5th Ed) 1979*

[2-14] See following letter from Tri-Stem (October 24, 1991).



October 24, 1991

Michael L. Ashcraft, CIA, CFE  
City Auditor  
City of Scottsdale  
3939 Civic Center Boulevard  
Scottsdale, AZ 85251

Dear Mr. Ashcraft:

The following comments are prepared in response to the letter of October 11, 1991, from Mr. Edwin D. Fleming of Burch & Cracchiolo, P.A. to you as it relates to Tri-Stem's input to your preliminary report on Utility Bill and Tariff Costs.

PAGE 3. III DRAFT JUNE 6, 1991, LETTER FROM TRI-STEM

- [2] 1) Paragraph 3 - The Scottsdale Water Supply Company references will be corrected to read Scottsdale Water Service Company.
- [3] 2) Paragraph 4 - The assertion that full amount of reimbursements recovered by Tri-Stem relate exclusively to EOS billings for variable costs of power and chemicals is factually incorrect. Among the most significant errors in terms of dollar totals was caused by EOS failure to correctly deal with fixed electrical costs as required by the contract. Also, there was recovery of the inventory amount which had been buried in the first year rate calculations.
- [4] 3) Paragraph 5 - Reference is to paragraph 3, page 3 (Tri-Stem's letter). There is nothing in Tri-Stem's comment that is factually incorrect. Additional information provided by Mr. Fleming, simply touts the range of his client's duties which are not an issue.
- [5] PAGE 4. Paragraph 1 - Statement that security is a third element in the payment formula is factually incorrect. Security charges are billed as a separate element outside of the formula. (This appears to be as a result of mutual agreement between EOS, SWSC and the City several years ago.)
- [6] PAGE 4. Paragraph 2 - Reference is to paragraph 1, page 4 (Tri-Stem's letter). Reference to Camp, Dresser, McKee will be removed and substitute will read "EOS and reviewed and approved by SWSC and the City."

ACCOUNTS PAYABLE ANALYSIS

[7] PAGE 4. Paragraph 3 - Reference is to paragraph 3, page 4 (Tri-Stem's letter). We will remove the comment, "The reason for the error was not determined."

[8] PAGE 4, Paragraph 4 & PAGE 5, Paragraph 1 - Reference is to paragraph 4, page 4 (Tri-Stem's letter). We will amend the second sentence in our paragraph to read as follows:

"We are unable to find any clear reference to any allowed markup percentage, except for an example...."

[9] PAGE 5, Paragraph 2 - How SWSC disposes or spends the 7.5% management fees paid for services and the range of SWSC's duties are not issues in this report. In response to the objections and comments made by Mr. Fleming, we will modify Tri-Stem's second sentence on page 5, paragraph 1 to read "In accordance with the contract"....

[10] PAGE 5, Paragraph 4 - The statement that all billings by SWSC to the city were accompanied by detailed backup invoices and related materials is a misstatement of fact. We now have copies of the necessary invoices and documents after having made repeated requests directly to EOS.

We are, however, willing to modify our statement on page 5, paragraph 3, to read as follows:

"To some extent, the inability to reconstruct costs and/or to adequately review billings is attributed to a lack of documentation offered by EOS (as routed through SWSC to the city). Lack of documentation was also a serious impediment to completion of our review."

[11] PAGE 6, Paragraph 3 - We have modified Tri-Stem's comment "Staff apparently relied on SWSC's indications that billings were correct" to read "Staff apparently assumed that SWSC billings were correct." In response to comments regarding what was relied upon, and the degree of care taken by SWSC and "diligence" as defined, the following is provided:

- a) ANY serious attempt to reconstruct billings provided by EOS (after adequate documentation was requested and provided) would have indicated a questionable markup percentage and any recalculation of rate adjustments would have uncovered an incorrect allocation of fixed electrical costs.
- b) SWSC's CPA submitted a bill dated December 15, 1987, for services described as "Audit of EOS Billings." This bill was approved by SWSC and sent to the City for payment.

Comment that "SWSC would not and, in fact, did not benefit from any overcharges by EOS".....The writer's indication that SWSC kept only a fixed amount of the management fees charged is completely unrelated to the fact that a 7 1/2% management fee was charged on the entire amount of EOS billings which varied from month to month. To the extent there

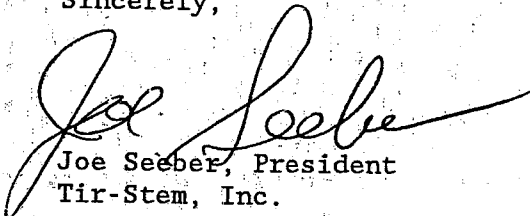


was an overcharge by EOS, the management fee of 7 1/2% applied by SWSC on that element of the billing is also an overcharge. To conclude otherwise ignores the fact that SWSC has willingly refunded \$26,456.55 to the city.

- [12] PAGE 7, Paragraph 2 - We will consent to removing the last sentence of paragraph 4, on page 5 (Tri-Stem's report).
- [13] PAGE 7, Paragraph 3 - We will consent to change of recommendation 1 to read "Exhibit B of the contract between SWSC and EOS...."
- [14] PAGE 8, Paragraph 2, Indication that SWSC's employment of a local CPA firm to review contract billings to the City was not represented as an "attestation" ignores the fact that at least one billing for services was presented by SWSC's CPA as services for "Audit of EOS invoices."
- [15] PAGE 9, Paragraph 3, Audit costs are not 49% of overcharges identified but rather 49% of overcharges recovered. Although immaterial to this report, the redeeming quality of this fee arrangement is effectiveness and results as compared to the fees paid on a rate and hour basis which in this case yielded nothing.

We trust that these comments are useful in resolving the objections as raised by Mr. Fleming of Burch & Cracchiolo, P.A. to Tri-Stem's portion of the preliminary report. If we can assist further in this regard, please contact us.

Sincerely,



Joe Seeber, President  
Tri-Stem, Inc.